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# Budgeting and Governing for Deficit Reduction in the UK Public Sector: Act One ‘The Comprehensive Spending Review’

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## Abstract

After the 2008 financial crisis, recession and subsequent collapse in government revenues, the UK's public deficit reached levels not seen since the Second World War. It had to deal with gearing by borrowing one pound for every four it spent. Before the 2010 election, all of the major parties agreed that tackling the deficit was a priority, and that spending reductions would play a major part. However, they did not agree over the timing and depth of cuts.

The Comprehensive Spending Review had been used for planning in times of certainty when Whitehall's strategic ambition was growth and centralisation was omnipotent. In contrast, in 2010 the Government's spending plans were set out for the next four years with the spending review process now being used for planning in times of uncertainty when the ambition is deficit reduction and localism is being favoured.

In public sector accounting research, little is known about how accounting for organisation changes occur in the spending review in periods of certainty, let alone uncertainty.

The purpose of this paper is to briefly consider the phoney war that took place after the financial crisis and how within the impending uncertainty the comprehensive spending review was used to provide a framework for a long term planning approach, which the annuality of the budget can take place within.

*Key Words: Spending Review, Budgeting, Governing, Public sector; Government and non-profit; Financial Crisis; Deficit Reduction*

## Public Sector Governing, Spending Review and Budgeting

Budgeting has become the great issue of our time. This is not an exclusively UK concern, but is an amplified international issue following the credit crisis and subsequent fallout. It is highly visible for countries with economies doing badly, but also affects those perceived to be doing relatively good due to fears of contagion and protectionism.

The budget is an attempt to allocate financial resources through political processes in order to serve different ways of life. Conflict therefore underpins every government spending review and budget process. Budgets with predictive value express in a visible manner the part to be played by government in society and thereby are the most operational expression of national priorities in the public sector. Compared to the rhetoric of party platforms and legislative forms, other than entitlements, inclusion of activities in the budget carries a higher probability of being delivered. This is because little can be done without resources, and what will be tried is embedded in the budget (Wildavsky 1964, 1975).

The interest of this paper is the United Kingdom, but with specific attention on England. Politicians and officers, whether in Whitehall or Town Hall, are spending as much time on taxing and spending as all other matters put together. To many it visibly appears that the great issue is the national deficit, but this masks the political significance and ideological importance behind discourses. The real issue that invisibly underlies the rhetoric is different. It questions fundamentally what kind of government are we going to have, and therefore what kind of citizens will we be? Will the budget be balanced at much higher levels of revenue and expenditure or at much lower levels? What role should the state play in activities? Is it a traditional provider state, an enabling state with an extended role that calls further and deeper on elements of new public management (Hood 1991, 1995) or an ensuring state that guarantees to step in for given activities when things go wrong (Giddens 2009). Alternatively, should the state remove itself completely from certain activities and manage expectations so citizens know that the state will not step into the breach as a last recourse. Citizens and other institutions are therefore made more responsible for activities that may be deemed public services, such as part of the Big Society.

In the UK, conceptions of political priorities are at odds for budget setting. The Coalition (Conservatives and Liberal Democrats) publicly stated they will cut the deficit fast and deep by drastically cutting public service spending. In the case of the Liberal Democrats this has meant retracting on certain election promises, which has already had an adverse impact upon them at the local ballot box. It is therefore a matter of conjecture whether the coalition will be able to continue such aggressive cuts without internal dissension increasing. In contrast the New Labour opposition have expressed their preference for continuing to spend on public services at relatively high levels and look to cut the deficit over a longer time frame.

The Coalition as the government in office has to make tough political choices and implement them. Following the phoney war of where cuts are being proposed, the first part of concrete action is the spending review that took place in October 2010, which is to be followed by the budget in March 2011. The spending review is important as it overcomes the annuality inherent in the public sector budget cycle. In this case it will provide a framework of expenditure levels over 4 years to 2014/15. The purpose of this paper is therefore to look at how the UK has used the spending review as the initial mechanism to deal with the visible deficit reduction, and more fundamental invisible issue of what kind of organisations we will have in the public sector and what kind of society we will be for citizens.

Accounting is a fundamental part of both making the tough political choices and implementing them. Accounting in action is not only a technical phenomenon, but an organisational and social phenomenon (Hopwood 1983). Accounting therefore is impacted by and impacts on the contexts it operates in.

In the early 1980's accounting was mobilised to visibly highlight expenditure to monitor, police and enforce accountability in the name of efficiency (Hopwood 1984) as the Thatcher Conservative Government restructured the state.

New Public Management principles increased as conceptions of markets and surplus were embedded in public sector practices, with the state being an enabler rather than purely a provider of services. The private sector was to play a greatly expanded role in public sector provision and accounting was manifested in changes for operational practice (Hood 1991, 1995).

As part of a New Public Management extension, targets and performance management arrangements expanded under both Conservative and New Labour administrations with the Government Regulator (the Audit Commission) broadening its remit from reporting on financial stewardship to performance assessment. Accounting and targets (Hood 2006) became the reality for building a new Jerusalem, with Lapsley (2009) lamenting at some of the dysfunctional implications of New Public Management.

Following the fallout from the financial crisis, in 2010 the coalition government decided the mass of targets in the public sector had gone too far and were expensive to administer in times of austerity. To signal their shift in emphasis from centralism in Whitehall to localism at Town Hall they disbanded the Audit Commission. However, the rhetoric of a move to localism was not matched with resources to implement this transition towards a big society.

Within the cold funding climate all political parties are agreed that cuts were necessary to deal with the budget deficit, but could not agree on the levels and timings. Jorgensen (1982, 1985, 1987) from observations of OECD countries' attempts at cutbacks in the 1970s argued policy makers entering continuing fiscal restraint after a long period of growth were likely to go through phases of analytic logic from incremental cutbacks to managerial reforms or broader system redesign and onto quantum or strategic cutbacks. However, Hood (2010) highlights that such analytic logic conflicts with political logic suggesting the lead-time for fundamental strategic changes is not necessarily longer than system redesign strategies and electoral cycle considerations may also favour early use of the former. The first and third type reforms may therefore precede the second type. As system redesign may be fundamental to any long term process

of adapting public services to a cold fiscal climate the policy challenge is to prevent the more quickly deployable first and third options from undermining the pursuit of the second in the medium term. This is a challenge, but has been done before. However, none of the three types is a panacea for achieving reforms that cut the cost of government and the public services without significantly reducing the quality and quantity of service provided. The difficulty of combining those two objectives is clear. Nevertheless, service or sector abandonment by the state is far from unknown by parties of various political persuasions and therefore remains a viable option.

The purpose of this paper is to briefly consider the phoney war that took place after the financial crisis and how the comprehensive spending review was used to provide a framework for a long term planning approach, which the annuality of the budget can take place within.

### **Spending Review as Accounting for Change**

The spending review was an accounting tool for change in periods of growth, but now it is being used to manage austerity. On 20 October 2010, Chancellor George Osborne set out the Government's spending plans for the next four years (HM Treasury 2010b). The rhetoric heralded a prolonged period of financial pain for public services. This was shortly followed in December by an announcement of grant funding central government would provide to local authorities over the next three years. It confirmed some councils face budget squeezes of nearly 9% for the 2011-12 financial year alone (CLG 2010a).

After the 2008 financial crisis, recession and subsequent collapse in government revenues, the UK's public deficit has reached levels not seen since the Second World War. Public spending increased from around 41% of GDP to 48% of national income between 2006-7 and 2009-10, whilst receipts fell to 37%. This meant central government was running a deficit of 11% and had to deal with gearing by borrowing one pound for every four it spent.

Before the 2010 election, all of the major parties agreed that tackling the deficit was a priority, and that spending reductions would play a major part. However, they did not agree over the timing and depth of cuts. Shortly afterwards, the Emergency Budget in June gave a taster of what was to come (see HM Treasury, 2010a), but this was only supposed to be an entrée with the Spending Review being hyped up as the main course moment for substantive details on how the Government aims to reduce the deficit over the next four years. Ministers then suggest that they will have paid off enough of the debt by 2014, which could offer up some pre-election tax cuts as dessert.

The Spending Review did set out huge reductions in public expenditure. Departmental spending is set to fall by 19% over the next four years to save £81 billion. This is in accordance with the Government's policy to eradicate the structural deficit by 2014-15, and to do so primarily by cutting spending, rather than increasing taxes. To put these figures into context, total public expenditure in the 2004-07 spending review period grew by just over 4% per annum in real terms, whilst it increased by around 2% per annum in real terms between 2007-10.

### **Levels of Departmental Cuts**

The finalisation of figures in the Spending Review should be considered a major achievement in itself. Ministers agreed to the largest prolonged reductions in public spending since the 1920s. This dwarfed Margaret Thatcher's attempts to shrink the state nearly thirty years ago. After months of negotiations behind the scenes, some parts of Whitehall have agreed to budget cuts of approaching 30% between now and 2015. Although other areas of spending – most notably the NHS, overseas aid and schools – have been largely 'protected' and in some cases will receive real terms increases, the cuts will still total £81bn over four years.

Departmental Expenditure Limits (DELs) have been set for the next four years to 2014-15 with 2010-11 used as the baseline. The total departmental programme and administration budgets for projected spending in cash terms at 2010 prices are 2010-11 £326.6Bn, 2011-12 £326.7Bn, 2012-13 £326.9Bn, 2013-14 £330.9Bn, 2014-15 £328.9Bn. The cumulative real growth in percentage terms is -8.3%. The figures do not take account of cuts to capital spending, or levels of Annually Managed Expenditure (AME). AME consists of spending such as benefits, tax credits and debt interest payments. This expenditure is much harder to predict than DELs, hence the Government tries to manage AME on an annual basis. Since the Chancellor announced significant additional savings in AME by slashing welfare payments, the cuts to DELs were not as severe as many people had feared. However, the inherent unpredictability of AME means that it is less likely that these extra savings can actually be realised.

The cuts will be phased in over four years. In some cases (such as English councils), the reductions have been front-loaded and will therefore require organisations to make massive cuts in 2011-12. This will be a huge challenge for the vast majority of public bodies, and may increase the prospect of a 'double-dip' recession, but it is more achievable politically and will allow the Government to pay off more of the debt sooner, thus reducing its debt interest payments over the medium term.

Health and overseas aid will receive increases just above the projected rate of inflation over the next four years, and schools will also benefit from protection. Since these services account for a large share of public spending, and total departmental budgets are being reduced by 19% over the next four years in cash terms, other departments have to bear the brunt of the cuts.

Nevertheless, most services face cuts and are outlined below.

### **English Local Government**

The Spending Review contains many proposals that will have a significant impact on local authorities. In particular, central Government funding streams for English councils will be cuts in real terms by 7.25% over each of the next four years (a total of 26% in cash terms). This means that authorities' budgets will shrink by an average of 14% once Council Tax is taken into account. There will also be a reduction in the number of specific grants from over 90 to less than 10, leaving just public health, schools, fire, policing and a handful of others (CLG 2010b). Although this appears to give councils greater freedom over how they can spend their money, the reality is more prosaic: many ring-fenced grants were targeted at specific initiatives in deprived parts of England, and therefore the changes will have an asymmetric impact across the country, with urban areas more adversely affected. Moreover, the overall reduction in funding essentially means that central government has 'devolved the axe' to allow local authorities to decide where the reductions will need to be made. As a result, cuts are inevitable in areas such as culture and leisure services and environmental health. In spite of the Government promising an extra £2bn for adult social care, many authorities will still need to reduce their commitments in this area in order to balance their budgets.

In addition to these reductions, the Communities and Local Government department (CLG) has requested that all local authorities freeze Council Tax in 2011/12, and will provide an extra £650m in annual funding over the next four years to cover the income they would otherwise have received. After 2011/12, any proposed increase in Council Tax that the Secretary of State believes is "excessive" will be subjected to a local referendum. Although this will replace the 'capping' of Council Tax, it will act as a cap in all but name. Only an extremely courageous, or foolish, authority would expect to win any such public vote.

The Spending Review also set out how the Government intends to pursue 'place-based-budgeting', by replacing its predecessor's idea of 'Total Place' with sixteen pilots of pooled "community budgets". These will begin from April 2011 and aim to bring together government spending that is aimed at families with complex needs, before being rolled out across England from 2013-14. A number of commentators criticised community budgets as lacking in ambition and not capable of delivering the level of benefits that Total Place promised.

Finally, housing budget is being halved over the next four years. The Government hopes to plug this gap by increasing council house rents for new tenants by up to 80% of the market rate, which is double what is currently charged. They will also introduce a New Homes Bonus, which aims to incentivise house-building by match funding the Council Tax on every new home for each of the following six years. Although it expects 150,000 homes to be built over the Spending Review period, the changes could result in housing waiting lists growing further if the housing market stays flat and developers remain reluctant to build new properties.

### **Police and Fire Services**

Central government funding for police forces will be reduced by 20% in real terms over four years, which will mean budgets are 14% smaller once Council Tax precepts are taken into account. Forces will have to deliver these savings at a local level, but realising them will be easier said than done, partly because it is against the law to make a police officer redundant. The Government has argued that savings of this size can be made from back office functions and bureaucracy, and by tweaking overtime pay and bonuses, but front-line services are almost certain to be affected.

Similarly, the Government argues that fire and rescue cuts can be achieved through operational improvements such as more flexible working, pay freezes, shared services, better procurement and possible service amalgamations. This service is facing funding reductions of 25% over four years, which is equivalent to a 13% real terms reduction in total expenditure.

### **Welfare and Benefits**

A large proportion of the savings (£7 billion a year, on top of the £11 billion already announced in the June 2010 Budget) will come from changes to the benefits system. These proposals include: capping the amount a workless household can receive in benefits; withdrawing Child Benefit from families with a higher rate taxpayer; reforms to public sector pensions; changes to eligibility for tax credits; and introducing a 12-month limit on the amount of time Employment and Support Allowance recipients can claim this benefit if their partner has a full-time job. Some of these changes could have a major impact in certain areas, as thousands of families may be forced to move house in order to cover their living costs on reduced levels of benefit. More generally, they are likely to increase poverty levels across the country, which could result in extra demands being placed on other public services.

The Spending Review sets aside £2 billion to fund the transition to the new universal credit over the next decade. However, Council Tax benefit will sit outside this new system, as it will be devolved to English local authorities from 2013-14. In addition, there will be a 10% reduction in the overall budget for this benefit, which could mean some residents are unable to pay their bills in full. This could mean that councils have to chase a large number of people for relatively small amounts of money. This state of affairs previously contributed towards the abolition of the poll tax.

### **Education and Children's Services**

The Government's idea of a 'fairness premium' (which will allocate a total of £7.2 billion to those schools that have children on free school meals over the spending review period) means that overall funding for schools remains roughly flat. However, the very nature of this mechanism means that schools with pupils from wealthier families will be subjected to cuts – whilst the significant cuts to Education Maintenance Allowance will affect poorer families.

As far as higher education is concerned, university funding will be cut by 7.1% per annum, and the remaining money will be channelled towards science, technology, engineering and mathematics. As a result, those institutions that do not specialise in STEM subjects face extremely uncertain futures, and undergraduate students will have to fund most of the costs of their tuition (up to £9,000 per year), in line with Lord Browne's recommendations.



## Health

The Government will increase funding for the health service by a total of 0.4 per cent in real terms over the Spending Review period, but the NHS will need to deliver 'efficiency savings' of £20 billion at the same time. It also represents the lowest increases in annual spending since the NHS was established – and will occur during a period of major change due to the reforms set out in the Health and Social Care Bill. In addition, given that the price of medicines and other health equipment rises much faster than inflation, most NHS managers will feel as though they are having to cope with smaller budgets.

## Central Government

The administration budgets of Whitehall departments and arm's length bodies will be cut by 34%. The reduction over four years is to be achieved by abolishing quangos, freezing pay, cutting jobs, improving approaches to procurement and property management and cutting non-essential expenditure. However, as a committee of MPs recently observed (House of Commons 2010), scrapping quangos is unlikely to save much money, due to the size of their liabilities and the fact that many of their functions will still need to be carried out, albeit by a different public body. Moreover, given the scale of the expected reductions, it is very unlikely that they can be achieved without major impact on front-line services.

## The Devolved Administrations

Funding for the devolved administrations in Scotland, Wales and Northern Ireland will also be cut, by an average in real terms of 7% over four years. These reductions are being applied differently in each territory. For example the Welsh Assembly Government has decided to reduce health spending in real terms, which means local authorities will only see a cut in their funding of 7.1% over the four years. This is much less than their English counterparts will have to deal with.

## Implications for the State's Role in the Public Service Model

Given the scale of the cuts, it is clear that traditional approaches to 'efficiency' that organisations have adopted since the Gershon review in 2004 are unlikely to be enough to deliver the necessary savings required (Jorgenssen 1982, 1985, 1987; Hood 2010). In most cases, there is very little extra scope for additional 'salami-slicing' or operational savings, meaning that many public services will either have to be delivered differently or not at all (Hood 2010).

This fits with the spending review's statement that the Government should no longer be the default provider of important services. Indeed, it may be the case that organisations may have little choice but to outsource some services. For example, the spending review document says that "the Government will look at setting proportions of appropriate services across the public sector that should be delivered by independent providers, such as the voluntary and community sectors and social and private enterprises" (HM Treasury 2010). These 'appropriate services' include adult social care, early years, community health services, pathology services, youth services, court and tribunal services, and early interventions for the neediest families.

The Localism Bill, which was published a few weeks after the Spending Review, takes these New Public Management principles of the state as a commissioner rather than provider of services a stage further (Hood 1991, 1995) despite criticisms in areas for their dysfunctional performance (Lapsley 2009). The Bill proposes to give private and third sector bodies the right to challenge an authority's provision of services. As a result, any potential provider will be able to propose that it could provide services more efficiently and effectively than the local authority. This has the potential to open the floodgates to numerous formal challenges and force councils to commission for the same goods or services several times, in order to allow the challengers to bid alongside other potential suppliers and perhaps an in-house team. A form of Compulsory Competitive Tendering would therefore result, but with potential providers cherry picking what they want to challenge. Regardless of the extent to which suppliers exercise this clause however, the financial situation will almost certainly lead to more outsourcing, as organisations right across the public sector seek to explore all avenues in order to try and reduce their costs.



## Risk Management

The major risk to the strategic ambitions of the Government's strategy is something that local public services have little control over, which is how the economy performs over the next few years. In order to cut spending by £81bn over the spending review period, the economy needs to grow at the levels predicted by the Office of Budget Responsibility (OBR) earlier in 2010. If growth is slower than expected (and the contraction in GDP for the final quarter of last year suggests that this is quite likely), then tax revenues will probably not be high enough to close the gap. Ministers have acknowledged that half a million public sector posts will disappear as a result of the cuts – and considering how much the private and third sectors depend on public spending, hundreds of thousands more could go from elsewhere in the economy. Many economists doubt that private companies will be able to create enough jobs to employ all of these people. The Government's economic strategy is based on the private sector creating 2.5m jobs within five years, which would ensure that there are posts available for unemployed public servants. Between 2000 and 2008 only 1.6m private sector jobs were created, although admittedly this was a period where jobseekers could also choose to apply for a lot of posts in public service organisations. This raises the prospect of much higher unemployment, slower growth and possibly even a 'double-dip' recession, as Ireland is currently experiencing. Even if the economy manages to expand in the first quarter of 2011 (and therefore avoids the 'double-dip'), there is a real chance of the UK experiencing a 'jobless recovery', which would not deliver the reductions in benefit payments and increases in tax revenues that the Government hopes to achieve.

Such a scenario would leave the Government with a major economic conundrum: whether to continue cutting spending in order to try and reduce the deficit and risk slowing down the economy even more, or to abandon its strategy and try to boost demand by cutting taxes or increasing spending. At the moment there appears to be no 'Plan B', and the debate around fiscal policy is going round in circles: some commentators argue that reducing the deficit is an essential pre-requisite for economic growth, whilst others counter that getting the economy moving again and people back into work is the best way of improving the health of the public finances. The only other option available would be for the Bank of England to stimulate growth through more quantitative easing, but this risks increasing inflation.

Of course, if the economy performs better than expected, the cuts may ease off slightly towards the end of the spending review period and provided employment levels increase as growth returns there will be more money left for departments to spend on services or for the government to reduce taxes. At the moment this is still uncertain.

In addition to the macro-economic risks, public service managers have various issues to consider when deciding where to make spending cuts locally. For example if an organisation decides to stop providing some discretionary services that may have a knock-on impact on statutory provision, which would raise questions about their legality. Cuts in some preventative areas (such as services for children or young people, or some types of adult social care) may mean that other departments or agencies are faced with additional demands and effectively result in cost-shunting. In many areas it will be difficult to get local politicians to agree to cut services, but in the end some compromise will need to be reached. Cuts to budgets such as corporate training or 'back office' areas are likely to store up problems for the future, as organisations could face a shortage of people with the right skills and experience to take them forward. Any redundancies need to be taken in the context of a robust workforce strategy. Some cuts will have a direct impact on the local economy, particularly in areas that are relatively more dependent upon public expenditure, such as Scotland, Northern Ireland, Northern England and the West Midlands.

## Concluding Thoughts

Since the late 1990s, central government has held regular spending reviews to set out departmental allocations for the forthcoming two or three years. This approach has been welcomed by managers across the public services, since it gives assurances about future funding levels and thus allows for longer-term planning. They have nevertheless been ambitious exercises, not least because they have to rely on inexact

forecasts about how the economy will perform over several years. Growth was relatively more certain, which facilitated incremental budgeting. However, growth is now uncertain and so incremental budgeting is to be interspersed with potential repetitive budgeting as conditions change, which is not good for confidence.

The 2010 exercise is taking the ambition for spending review capabilities to a new level. Not only does it cover four years rather than two or three, but it also demands spending reductions that have not been seen for generations. Hundreds of thousands of public sector jobs are expected to disappear as a result, and the knock-on effect of this on the wider economy cannot be predicted with any degree of confidence. A number of economists have warned that such moves will slow down the rate of growth and job creation, or even trigger another recession. This scenario, which would mean that public revenues stay low and welfare and interest payments remain high for much longer than the Government hopes, would only exacerbate the current deficit problem and leave the public finances back at square one.

In spite of this doom and gloom, it is worth pointing out that the cuts outlined in the spending review will only bring public expenditure as a proportion of GDP back down to 2006-07 levels. Indeed, total managed expenditure is actually forecast to increase from £697bn to £740bn over the next four years. However, it is worth remembering that the Government will be spending far more on benefits and debt interest in 2015 than it did eight years previously – the annual debt interest bill alone will increase from £43bn to £63bn over the spending review period. This means there will be much less left for departments to spend on services. In addition, demographic changes will exacerbate the fiscal squeeze, as the post war ‘baby boomer’ generation reaches 65 and an increase in school-age children places extra demands on schools.

These points raise another, possibly more pertinent, issue: whether the ambitious proposals in the Spending Review can actually be delivered. For example, many of the proposals (such as slashing Whitehall administration budgets by a third) are lacking in detail as to how they can be achieved and could be described as unrealistic. Perhaps more importantly, governments in the 1970s and 1980s were met with widespread strikes and civil unrest when they tried to implement spending cuts that are modest in comparison to what the coalition is proposing. Since the 1950s, the Government has only achieved real-terms cuts of more than 1% in current public spending in two financial years: 1977-78 (shortly after the International Monetary Fund intervened in the economy) and 1988-89 (at the height of the Lawson boom). Although reducing the level of inputs does not necessarily lead to poorer outputs and outcomes, cuts of this scale and speed will have a negative effect on services, at the very least in the short term. Unless the public is happy to settle for fewer services of lower quality – and there is little evidence to suggest that they have lowered their expectations – further protests from trades unions and citizens are inevitable. Prior to the spending review, the coalition had already incurred the wrath of various groups of people, including school leavers wanting to go to university, stay-at-home middle class mothers, public sector workers, and a large proportion of Liberal Democrat voters. Once the cuts begin to bite, others will no doubt join this list.

The ‘phoney war’, in which cuts to services have been discussed, is now over. As a recent publication (CIPFA 2010) suggested, we have now reached “the end of the beginning”, and spending reductions will shortly become real for citizens, families and communities. It remains to be seen whether the coalition, particularly its Liberal Democrat members, is able to withstand the slings and arrows of public opinion and implement this agenda over the next few years. Considering the highly political nature of these issues, as well as the economic uncertainty, another spending review could be necessary. If this is the case expectations management will be fundamental to at least maintain confidence.

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